

**COORDINATED ISSUE
ALL INDUSTRIES
AMORTIZATION OF ASSEMBLED WORKFORCE**

ISSUE:

Whether an assembled workforce is an amortizable asset and, if so, how the useful life and value of the asset can be determined.

BACKGROUND:

The assembled workforce issue generally arises in the context of a stock acquisition which is followed by a step-up in basis of the acquired corporation under former I.R.C. § 334(b)(2) or under section 338. This issue may also arise in the context of an asset acquisition where a lump sum purchase price for the acquired business is allocated by the purchaser among the various component assets of the business. Stock and asset acquisitions in which intangibles issues arise typically involve the payment of a premium over the net fair market value of the tangible assets of the acquired corporation or business. To minimize the amount allocated to nonamortizable goodwill and going concern value, a taxpayer may allocate a large amount of the purchase price to various intangible assets and assign useful lives to these assets for purposes of claiming amortization under section 167. One such intangible asset which may be claimed is known as "assembled workforce" or "workforce in place." The assembled workforce intangible represents the value inherent in having a trained staff of employees in place. It is limited to employees who do not have employment contracts.

DISCUSSION:

The purpose of this paper is to explain how to deal with a taxpayer's assembled workforce claim relating to taxable periods prior to the enactment date of I.R.C. § 197 (August 10, 1993). Historically, the Service took the position that an assembled workforce was nonamortizable as a matter of law. However, recent developments in the case law make it clear that the amortization of any intangible asset (including assembled workforce) is a question of fact, requiring both the Service and the taxpayer to develop the issue in terms of useful life and value.

The Two-Prong Test for Amortization

Section 167(a) is the controlling provision for the allowance for amortization of intangible assets acquired prior to the enactment date (or

election-back date, where applicable) of section 197.¹ Although section 167(a) does not specifically refer to intangible property, Treas. Reg. § 1.167(a)-3 recognizes that an intangible asset may be amortizable. Treas. Reg. § 1.167(a)-3 requires that the following factors be present before a deduction is allowable:

- * The intangible asset is known from experience or other factors to be of use in a trade or business or in the production of income for only a limited period of time, the length of which can be estimated with reasonable accuracy.
- * The deduction for depreciation is not for goodwill.

The regulation also provides that no depreciation deduction is allowable with respect to goodwill. By implication, this provision extends to going concern value as well. See United States v. Cornish, 348 F.2d 175 (9th Cir. 1965). Goodwill and going concern value are nondepreciable as a matter of law because of the difficulties inherent in the computation of their decline and because their initial value is difficult to appraise. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974); Dodge Brothers v. United States, 118 F.2d 95 (4th Cir. 1941); United States v. Cornish, 348 F.2d 175 (9th Cir. 1965) (going concern value is nonamortizable as a matter of law). See also Southern Bancorporation v. Commissioner, 847 F.2d 131 (4th Cir. 1988). While goodwill and going concern value are often referred to conjunctively, they are different conceptually. Technically, "going concern value" represents the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership. Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 232 (1975). See also UFE, Inc. v. Commissioner, 92 T.C. 1314, 1323 (1989); Solitron Devices, Inc. v. Commissioner, 80 T.C. 1, 19-20 (1983), aff'd without published opinion, 744 F.2d 95 (11th Cir. 1984). Going concern value is "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern." VGS Corporation v. Commissioner, 68 T.C. 563, 591 (1977).

The Service historically took the position that an assembled workforce intangible was nonamortizable as a matter of law, inasmuch as the value associated with having a trained staff of employees in place represented the going concern value of the acquired business. Prior case law supported this position. See, e.g., Decker v. Commissioner,

¹"Depreciation" and "amortization" are used interchangeably. Generally, "depreciation" refers to an allowance for the wear, tear, exhaustion or obsolescence of a tangible asset. "Amortization" refers to the periodic recovery of the cost of an intangible asset. Both terms, however, describe the same concept, cost recovery, for which authority is found in section 167(a).

T.C. Memo. 1987-388, aff'd, 864 F.2d 51 (7th Cir. 1988); Fong v. Commissioner, T.C. Memo. 1984-402.

However, prior case law has been modified by the Supreme Court's holding in Newark Morning Ledger Co. v. United States, 507 U.S. ___, 113 S. Ct. 1670, 123 L.Ed.2d 288 (1993), rev'g 945 F.2d 555 (3d Cir. 1992), rev'g 736 F. Supp. 176 (D.N.J. 1990). Newark Morning Ledger addressed the issue whether a "paid subscriber base" intangible represented an asset that was indistinguishable from the goodwill of eight acquired newspapers. The government argued that value of the 460,000 "paid subscribers" -- which lay in the expected future income stream to be generated by those subscribers -- represented the very essence of goodwill value, and therefore was not depreciable as a matter of law. The Supreme Court rejected the government's contention, holding that

a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage.

113 S. Ct. at 1681 (emphasis supplied). The Supreme Court reasoned that if a taxpayer is able to establish that an intangible asset can be valued and that it has a reasonably estimable limited useful life, then the asset is necessarily separate and distinct from goodwill. "The entire justification for refusing to permit the depreciation of goodwill evaporates, however, when the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time." 113 S. Ct. at 1680.

In Newark Morning Ledger, the government did not attempt to rebut the taxpayer's evidence of useful life and value of the asset, relying instead on the argument that amortization of the asset should be disallowed as a matter of law because the "paid subscriber base" was goodwill. The case was lost because the Supreme Court held that depreciability of an intangible asset is a question of fact, and the taxpayer without rebuttal evidence from the government met its burden of proof. The lesson of Newark Morning Ledger is that the Service has to factually develop cases involving intangible assets, or else expect to lose these cases.

The opinion in Newark Morning Ledger is very broad and cannot be limited to customer based intangibles, nor should it be read as limited only to assets in the nature of goodwill. There is no legal justification for not extending the holding to assets in the nature of going concern value, as the Fourth Circuit recognized in Ithaca Industries, Inc. v. Commissioner, 17 F.3d 684 (4th Cir. 1994), aff'g 97 T.C. 253 (1991).

Ithaca Industries involved a claimed "work force in place" (assembled workforce) that the taxpayer acquired upon its purchase of another corporation. The taxpayer assigned an average per capita amount to each of its hourly and production workers

and salaried employees, and amortized that amount when each person's employment terminated.

In Ithaca Industries, the Service took its historic position that an assembled workforce intangible was, as a matter of law, nonamortizable going concern value. The Tax Court, reaching its decision prior to the Supreme Court's opinion in Newark Morning Ledger, rejected the Service's argument, holding that such an asset is amortizable if the taxpayer can establish its limited useful life and value with reasonable certainty. Nevertheless, the Tax Court found as a factual matter that the taxpayer had not established that an assembled workforce has a limited useful life. The Tax Court, viewing the workforce as a whole, found that the asset will not diminish as the result of time or use:

In this case, it is "the assembled work force" that petitioner claims is a wasting asset, not each individual worker. Although the assembled work force is used to produce income, this record fails to show that its value diminishes as a result of the passing of time or through use. As an employee terminated his or her employment, another would be hired and trained to take his or her place. While the assembled work force might be subject to temporary attrition as well as expansion through departure of some employees and the hiring of others, it would not be depleted due to the passage of time or as a result of use. The turnover rate of employees represents merely the ebb and flow of a continuing work force. An employee's leaving does not interrupt or destroy the continued existence of the whole. To the extent the leaving of any employee reduces the value of the assembled work force as a whole this value would be restored by the hiring of a new employee.

97 T.C. at 267. The government prevailed on the assembled workforce issue in Ithaca Industries due to the taxpayer's failure to meet its burden of proof.

The Burden of Proof

It is clear from the majority opinion in Newark Morning Ledger that a taxpayer claiming amortization of an intangible asset has a substantial burden to establish (1) that the taxpayer has accurately determined the anticipated useful life of the claimed value of the asset, and (2) that the taxpayer has accurately determined its value. The Supreme Court acknowledged that

Although we now hold that a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life ... , we do not mean to imply that the taxpayer's burden is insignificant. On the contrary, that burden will often prove too great to bear.

113 S. Ct. at 1681.

The heavy burden of establishing the useful life and value of an assembled workforce is illustrated by Lthaca Industries, Inc. v. Commissioner, *supra*. As proof of the limited useful life of the assembled workforce, the taxpayer had offered statistical data that purported to measure the rate at which the 5,149 workers employed by Lthaca on the date of the merger could be expected to terminate their employment over the subsequent years. This statistical method, taxpayer contended, provided an accurate measurement of the useful life of the assembled work force. The Tax Court disagreed. Finding this analytical approach flawed, the court stated, "[t]he rate at which the individual employees who make up the work force on a specific day will leave their jobs is not a determination of the length of time an assembled work force as an entity will be an intangible asset of the business." 97 T.C. at 272.

Where the Tax Court had found that the assembled workforce was a nonwasting asset, the Fourth Circuit believed that the assembled workforce was a wasting asset that began to decline as a result of resignations, terminations, retirements, and deaths of individual workers. After analyzing the statistical evidence that the taxpayer had offered, however, the Fourth Circuit concluded that the data did not accurately measure the useful life of the assembled workforce asset. In the Fourth Circuit's view, "there can be no defensible estimation of the duration of any one person's employment, nor of the useful life of the workforce of which he or she is a part." 17 F.3d at 689. The court noted that the decline rate of a workforce is susceptible to a number of influences, constantly changing, and affecting both the employer and the employee -- influences for which the taxpayer [in its statistical methodology] cannot control. 17 F.3d at 690. These influences, operating both in and out of the workplace, "inject[] vagaries into the useful life analysis." 17 F.3d at 690 n.15. The characteristics of the assembled workforce asset, in other words, "suggest no sufficiently accurate means of estimating its useful life." 17 F.3d at 690.

Because both the Tax Court and the Fourth Circuit viewed the taxpayer's evidence of useful life as deficient, neither court had to address the second prong of the Newark Morning Ledger test: whether the value of the assembled workforce had been established with reasonable accuracy. It is worth noting, however, that the Fourth Circuit intimated that the taxpayer's method of valuing the assembled workforce was not sufficient to meet its burden of proof. The taxpayer arrived at a value for its assembled workforce by calculating the avoided cost of recruiting and training new employees. In a footnote, the Fourth Circuit stated:

We must note, however, our concern with Lthaca's use of the cost of recruiting and training replacement workers as a proxy for the value of the workforce obtained from Old Lthaca. The two groups of workers may not be sufficiently comparable to allow this approach.

17 F.3d at 689 n.12.

Treatment of Assembled Workforce Under Section 197

Amortization of an assembled workforce asset is not an issue for transactions occurring after August 10, 1993, the date of enactment of new Code section 197. Section 197 provides for 15-year straight line amortization of acquired intangible assets (called "section 197 assets") beginning with the month of acquisition. No other deduction for depreciation or amortization is allowed for amortizable section 197 assets. Except for a limited election for intangibles purchased after July 25, 1991, the legislation is not retroactive.

Section 197 applies to most intangible assets acquired after the date of enactment; the 15-year amortization provision generally does not apply to self-created intangibles, churned assets, and certain specified intangibles (such as separately acquired mortgage servicing rights, sports franchises, and off-the-shelf computer software). Included among the intangibles defined as "section 197 assets" is assembled workforce.

EXAMINATION POSITION:

In view of the Supreme Court's holding in Newark Morning Ledger, it is not appropriate to view the assembled workforce asset as nonamortizable as a matter of law. If a taxpayer is able to establish the limited life and value of any intangible asset (including assembled workforce), the asset may be depreciated over its useful life. However, this is not an easy task for taxpayers. Ithaca Industries illustrates that the courts demand strong proof of useful life and value with respect to assembled workforce.

While the Fourth Circuit effectively closed the door on lifing an assembled workforce, finding it nearly impossible to prove the useful life with the requisite degree of accuracy, it is conceivable that other circuit courts might find otherwise. Because taxpayers will attempt to establish the life and value of their assembled workforce assets, the Service must carefully examine the lifing and valuation methods that the taxpayer has used, and determine whether infirmities exist in the data. Any statistical methodology that purports to measure the useful life of a workforce based on historical attrition rates of individual employees will suffer from the shortcomings of the taxpayer's evidence in Ithaca Industries.

Because a case involving an assembled workforce requires factual development, examining agents are urged to consult a Service engineer or economist (or an outside expert in appropriate cases) for lifing and valuation assistance. Although a taxpayer generally has the burden of proof with respect to the claimed useful life and valuation, the Service should always be able to specifically demonstrate why a taxpayer's

appraisals or assertions are erroneous. General guidance on critiquing taxpayers' appraisals may be found in the Intangibles Settlement Initiative Teleconference Handbook, Internal Revenue Service Document 9233 (2-94), Catalog Number 20566N.